QUALITY INVESTING SERIES - VOL.1

WHAT IS IT, AND WHY SHOULD YOU CONSIDER USING THIS STRATEGY?

To answer the second part of the question is easier. In short, it seems to have led to better returns than the general stock market over a long period of time, and is investing in its most simplest form. Sounds good! So, what is it?

This is the hard part. There isn't really any standard definition in investment lore or financial education curricula. In the years I spent studying for an economics degree, the Asset Management Certificate from Wharton, University of Pennsylvania, and 16 financial services professional exams (across 3 different countries), I've never come across this style of investing. It is only through my own research and reading over the years that I've learned about Quality investing. It rarely comes up in the financial press, have you heard of it before?

Yet it is not a new concept. Legendary investor Benjamin Graham, Warren Buffett's mentor and university professor, mentions Quality companies back in the 1930s. He classified stocks as either Quality or Low Quality and observed that the greatest losses were not seen from buying a stock at a high price if it was a Quality company, but rather from buying Low Quality stocks at a good value price. Interesting given he is known as the 'father of value investing'!

Value investing is a well known concept. So too is Growth investing and other factor styles such as Momentum. Many asset managers with funds use these themes, and we hear about them all the time. The definitions are very clear. For example, value investing typically looks at P/E (Price to earnings) ratios and P/B (price to book) ratios to try to ascertain if a stock is trading at below its intrinsic value. Growth stocks will be assessed based on EPS (earnings per share) and earnings growth prospects. But how do we define Quality companies?

The S&P 500 Quality Index looks at ROE (return on equity), accruals ratios, and leverage ratios to give a 'quality score'. The MSCI World Quality Index looks at ROE and stable and consistent earnings growth. Terry Smith of Fundsmith LLP, who runs the UK's largest fund and whom I've had the pleasure to meet a number of times, looks at, amongst other factors, ROCE (Return on Capital Employed), resilience of the business, market advantage, and not needing leverage to generate returns. Dr Ian Mortimer of Guinness Asset Management, another with whom I have fortunately met, defines quality as profitable businesses with a consistently high Return on Invested Capital (ROIC). AQR Capital Management, based in Connecticut, USA, with over USD 185 billion in Assets Under Management, define Quality based upon low earnings volatility, high margins, high asset turnover, low leverage, and low stock specific risk.

So, there are numerous differing factors, but some common themes, leading to my personal definition of a Quality company being one that is:

A market leading, profitable business with a wide moat (sustainable competitive advantage), little or no leverage, a strong balance sheet and high margins. It should not be highly cyclical, and have stable and proven leadership and governance, and a record of effectively using capital well, and consistently for a number of years.

ROE, ROCE and ROIC are all different, but essentially tell how effective a company is at using capital to make shareholders money. On that, a last one to add in should be this focus on shareholder benefit. This could be through buybacks or dividends (which should also grow and be easily covered by free cash flow).

> **Leaving the question of price aside, the best business to own is one that over an extended period of time can employ large amounts of incremental capital.**
>
> –Warren Buffet

Phew, that was easy wasn't it! In fact, when you think about it, it is. It's really just 'investing 101'. Rather than trying to time the market and read news, assess prices, earnings, forecast future earnings, and value etc (don't forget traders and institutions have already done this before we even begin to think about it), let's keep it real simple. Invest in a company that is a market leader in their industry, run well, looks to provider returns to shareholders, is financially strong, and is consistently profitable. Then hold it for the long term until these elements change.

Makes sense now, but is the performance really better than the market?

In short, yes. Let's look at the funds by two of the managers I mentioned above. Looking back 1 year from the date I am writing this I think is interesting as it incorporates a strong 2019 (so far) and also the awful month of December 2018. Fundsmith Equity Fund has made +17.73%, Guinness Global Equity Income has made +16.70% and the MSCI World index has made +13.62%. That's a significant out performance for these managers who follow a Quality investing strategy.

Fundsmith Vs. Guiness Asset Management

Now before the sceptics speak out, I've rebased all the strategies to USD so there are no FX anomalies, and yes, the returns are net of the fund manager's fees, which, yes, are higher than an MSCI World ETF but yes, the net return is superior.

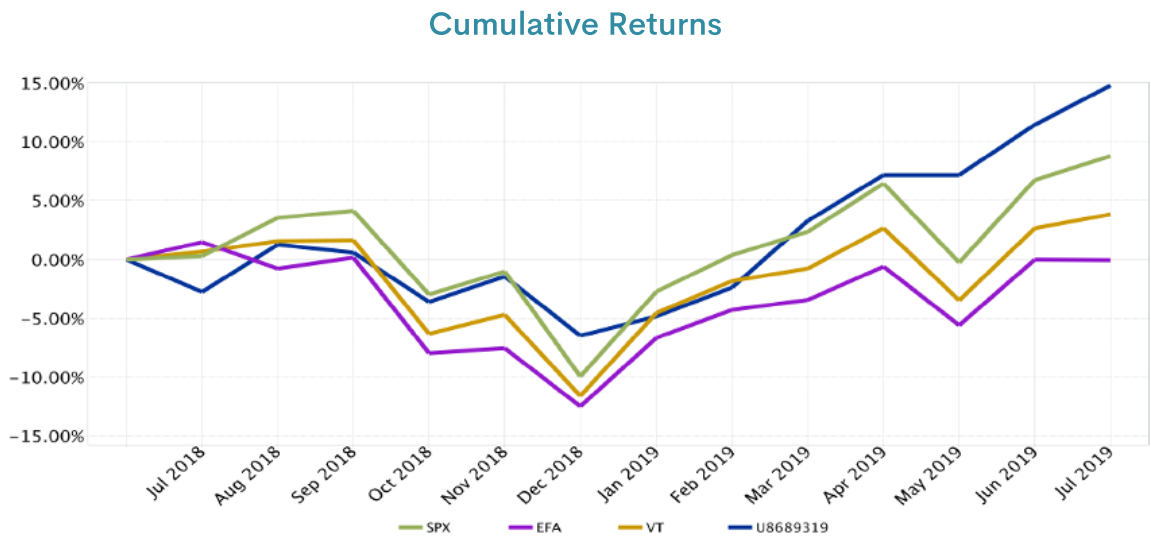
Maybe it is just the fund manager's skill in this case. Maybe it's not fair to use them as an example of why one should invest in quality stocks. According to the MSCI website, the MSCI World Quality index is up in the same period +15.66%, which is better than the general stock market (represented by MSCI World).

Quality Investing Funds vs Quality Company Index vs General Stock Market 1 year performance

MSCI World	+13.62%
MSCI World Quality	+15.66%
Guinness Global Equity Income	+16.70%
Fundsmith Equity Fund	+17.73%

I also wouldn't consider myself a "skilled fund manager". I am a financial planner, private investor, and entrepreneur. But I can see a similar pattern with my own Quality company investing portfolio.

I publicly disclose all of my own investments on my website **(www.pryor-ifa.com)** and 'tweet' about what I invest in on my Twitter account **(@ian_james_pryor)**. Whilst I do not disclose all the exact buys, sells and weightings, I do have trading history statements which incorporate all of this. My personal Quality company portfolio has seen similar good results, namely beating the general stock market, by simply buying and holding these Quality companies. You will see below, it's quite a considerable outperformance after the 1st year of doing this myself.

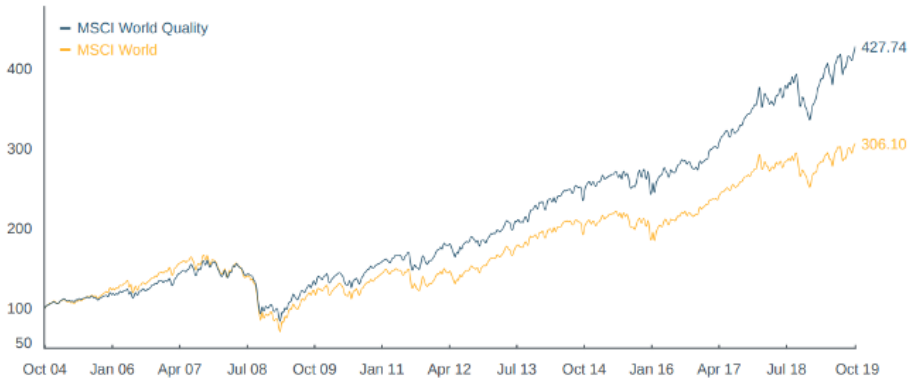


That's a +14.77% return. SPX is the S&P500, EFA is the iShares EAFA ETF (basically developed stocks excluding USA and Canada), and VT is the Vanguard Total World ETF (pretty much MSCI World). Hmm, maybe I am a skilled fund manager after all!

The next question will be what about over the long term? Business cycles are long and we've had a good market for a decade now. Maybe Quality investing only worked this past year? Data from MSCI goes back to 2005 so this should give us a strong indication as to whether or not this is an effective long term strategy or not. I am not surprised to find that it is.

CUMULATIVE INDEX PERFORMANCE - GROSS RETURN

(USD) (OCT 2004 - OCT 2019)



ANNUAL PERFORMANCE (%)

Year	MSCI World Quality	MSCI World
2018	-5.06	-8.20
2017	26.64	23.07
2016	5.12	8.15
2015	4.25	-0.32
2014	9.01	5.50
2013	27.74	27.37
2012	13.66	16.54
2011	4.43	-5.02
2010	11.36	12.34
2009	33.49	30.79
2008	-33.47	-40.33
2007	16.76	9.57
2006	16.78	20.65
2005	6.00	10.02

The chart speaks for itself, that really is quite a considerable outperformance. Not only is the total return far higher, but the downside risk is less. In 2018 we saw two market corrections occur, yet Quality lost -5.06% whereas the stock market lost -8.20%. 2008 was one of the worst years for markets in history, yet Quality still lost less than the market. Quite interestingly, the 10 year annualized volatility, one measure of risk, is 12.08 which is about 1% lower than the volatility of the general stock market.

Investing today is challenging. We've had a very long upward market trend, and economic growth is slowing around the world. But even if we are late in the business cycle, the sectors that perform the best are often filled with Quality companies. Think things like Consumer Staples and Healthcare. Fearful of a recession and bear market around the corner? Well don't be. As Peter Lynch once said "Far more money has been lost by investors preparing for corrections, than has been lost in corrections themselves". Still worried? Just look back at the 2008 data to see how quality loses much less than the market, but also look at 2009 and see that it bounces back further and faster.

> **My personal definition of a Quality company being one that is: A market leading, profitable business with a wide moat (sustainable competitive advantage), little or no leverage, a strong balance sheet and high margins.**

In summary, both in the recent short term, and over more than one bull and bear market cycle, Quality companies have beaten the market and with less risk. How good it would be to not worry about earnings reports, the financial press, analyst estimates, valuation models etc. Remember, it's simple investing for the long term.

Again, my definition of a Quality company is: a market leading, profitable business with a wide moat (sustainable competitive advantage), little or no leverage, a strong balance sheet and high margins. It should not be highly cyclical, and have stable and proven leadership and governance, and an effective record of using effectively using capital well, consistently for a number of years.

Sounds like such an obvious investing criteria doesn't it? Amazing it just isn't so well known. Keep my definition in mind and I'll leave you with four well known Warren Buffett quotes:

"Never invest in a business you cannot understand", "It's far better to buy a wonderful company at a fair price, than to buy a fair company at a wonderful price", "If a business does well, the stock eventually follows", and "only buy something that you'd be perfectly happy to hold if the market shut down for 10 years". For more information on how to access such strategies, or to discuss the merits of factor investing and Quality companies, please do not hesitate to contact me.